No. 16051

United States Court of Appeals

For the Ninth Circuit

AMERICAN PROPERTIES, INC., and the Estate of STANLEY S. SAYRES, Deceased, HAROLD L. SCOTT and A. R. MUNGER, Executors, and MADELEINE A. SAYRES,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR REVIEW OF DECISION OF THE TAX COURT OF THE UNITED STATES
HONORABLE CRAIG S. ATKINS, *Judge*

BRIEF OF PETITIONERS ON REVIEW

KENNETH P. SHORT
Attorney for Petitioners on Review.

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United States Court of Appeals

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American Properties, Inc., and the Estate of Stanley S. Sayres, Deceased, Harold L. Scott and A. R. Munger, Executors, and Madeleine A. Sayres, *Petitioners,* vs. Commissioner of Internal Revenue, *Respondent.*	No. 16051

Petition for Review of Decision of the Tax Court of the United States

Honorable Craig S. Atkins, *Judge*

BRIEF OF PETITIONERS ON REVIEW

JURISDICTION

The Tax Court of the United States acquired jurisdiction of these consolidated causes by the petitioners having filed in that court their respective petitions for redetermination of deficiencies in income tax (Tr. 3 to 10, 13 to 23). Jurisdiction in the Tax Court of such causes is conferred by 26 U.S.C. 6213 and 26 U.S.C. 7442.

Jurisdiction to review the decisions of the Tax Court of the United States is conferred upon this court by 26 U.S.C. 7482.

STATEMENT OF THE CASE

The petition of American Properties, Inc., filed in the Tax Court under its Docket No. 57748, sought a redetermination of deficiencies asserted by the Commissioner in income taxes for the calendar years 1949 and 1950 and asserted (Tr. 3 to 6) error of the Commissioner "in disallowing for the year 1949 the cost of taxes, maintenance and operation of racing boats in the amount of $2,155.56 as not being an ordinary and necessary business expense," and asserted the same error in 1950 in disallowing such expense in the amount of $11,388.43, and in disallowing depreciation on said boats and equipment in 1950 in the sum of $5,830.84 "as not being assets used in the trade or business of petitioner and not held for production of income" (Tr. 3-4).

In Tax Court Docket No. 57751 Stanley S. Sayres (for whom the executors have been substituted) and wife petitioned the Tax Court (Tr. 13 to 23) for a redetermination of deficiencies in income taxes for the fiscal years ended October 31, 1949, and October 31, 1950, in the respective amounts of $10,400.69 and $12,-830.51, or a total of $23,231.20 for both years. In that petition error is asserted in increasing petitioners' "other income for the year ended October 31, 1949, in the sum of $16,401.51" purportedly received from American Properties, Inc., and in increasing petitioners' "other income for the year ended October 31, 1950, in the sum of $16,595.31" purportedly received from American Properties, Inc. (Tr. 13-14).

Without going into the mathematical detail, it is

sufficient here to say that what the Commissioner disallowed as expense to American Properties, Inc., he posted as income to Mr. and Mrs. Sayres, sole stockholders of American Properties, Inc.

Other issues, principally salary questions, are raised by the petition of Mr. and Mrs. Sayres in Tax Court Docket No. 57751, and were ruled on adversely to the petitioners and are not raised on this appeal.

The Tax Court made the following Findings of Fact insofar as the same are pertinent to this petition for review (Tr. 27-40):

> "The petitioner, Stanley S. Sayres and Madeleine A. Sayres, are husband and wife, and the petitioner American Properties, Inc., is Stanley S. Sayres' wholly-owned corporation. The individual petitioners reported their income on a fiscal year basis ending October 31. The corporation keeps its books and reports its income on a calendar year basis. The individuals filed separate income tax returns for the taxable year 1948 and filed joint returns for the taxable years 1949 and 1950. These returns and the returns of the corporation for the years 1949 and 1950 were filed with the collector of internal revenue at Tacoma, Washington. The petitioner Stanley S. Sayres is referred to hereinafter as the petitioner, or as Sayres, and the petitioner American Properties, Inc. is sometimes referred to hereinafter by name or as the corporation.
>
> "Prior to 1931 the petitioner was engaged in the automobile business in Pendleton, Oregon. In that year he went to Seattle and purchased Williams Auto Company, a corporation, the name of which he changed to American Properties, Inc. (one of

the petitioners herein). During the years in question he owned all the stock of the corporation except a qualifying share, which was held by his attorney. The petitioner also purchased stock of American Automobile Company. During the years in question he was also the principal stockholder of that corporation. That company operated an automobile dealership and was a tenant of premises owned by American Properties, Inc.

"The petitioner has always enjoyed speed and it had been his desire to drive a boat faster than anyone had ever done before. Prior to going to Seattle he had engaged in outboard motor boat racing.

"After moving to Seattle the petitioner for several years did not engage in boat racing. However, at some time prior to 1948 he purchased a used racing boat which had previously attained a speed of 80 m.p.h., and he named it Slo-Mo-Shun. Thereafter he built successively Slo-Mo-Shun II and Slo-Mo-Shun III. In the design, construction, operation, and maintenance of Slo-Mo-Shun III, the petitioner retained technical assistance of experts who were recognized as outstanding in their fields. Since Ted Jones, the boat designer, was employed on a full-time basis as an engineer with an airplane company, his work for the petitioner was done at nights, on week ends, and on holidays. Anchor Jensen, of the local boat building firm, Jensen Motor Boat Company, was the builder. The petitioner, Jones and Jensen watched the 1948 Gold Cup races in Detroit in August, 1948, and after their experience with the first Slo-Mo-Shun and Slo-Mo-Shun II and III they recognized the tremendous room for improvement in the designing of racing boats. At that time they also recog-

nized the possibility of profit to be made in the designing, construction and sale of racing boats. They considered the possibility that the Navy might become interested in the basic design of these fast boats and might become an important customer. Jones proceeded to design Slo-Mo-Shun IV which would be revolutionary in the field of unlimited hydroplane boats. He used the identical design which he had used for years in building and racing limited class boats. By August, 1949, Jones and the petitioner concluded that Slo-Mo-Shun IV, which was then in the process of construction, would prove to be far superior to boats currently being used.

"The petitioner had consulted his attorney, his accountant, and his financial adviser, an official of the Seattle-First National Bank, who all agreed on the profit possibility in the designing, building, and sale of boats. The banker advised against the petitioner's undertaking any such business enterprise in an individual capacity. In discussions with the attorney the petitioner suggested that inasmuch as the Articles of Incorporation of American Properties, Inc. already contained provisions which would authorize the construction and sale of boats and marine supplies or engines, such corporation might undertake the venture without the necessity of creating a new corporation.

"The minutes of a meeting of the directors of the corporation held on August 31, 1949, contain the following:

"Preliminary discussions had been had with reference to this corporation entering the field of boat building, ownership and management. Counsel reported that the Articles of Incorporation

were sufficiently broad to warrant entry upon such a program.

"Mr. Sayres in connection with the country-wide interest in power boat racing suggested that 'Slo-Mo-Shun III, was in his opinion far superior to the major racing boats; that an improvement in design had been perfected and in his opinion 'Slo-Mo-Shun III' was by no means the last word in the field. In other words, there would be continuous improvement and if sufficient time was devoted to experimental and engineering work other boats would become obsolete and the Seattle boat would be the pattern all over the country.

"He suggested that he believed if the company would enter the field, do the necessary experimental and engineering work that not only was there money to be made in the manufacture and sale of racing crafts, but in the commercial field as well. That he believed the Government would itself be interested in the fastest type of boat that could be manufactured.

"It was recognized that there would be substantial experimental cost to lay the groundwork for future development.

"He further stated that he was willing to transfer title of Slo-Mo-Shun III to the corporation if the corporation would continue in an endeavor to work out improvements in design and engineering. He particularly suggested that a new improved Slo-Mo-Shun should be designed and built for actual racing use.

"Mr. Sayres also advised that he had substantial offers for Slo-Mo-Shun III and had no doubt of the saleability of Slo-Mo-Shun the IVth and boats of that design and class.

"It was agreed that it was to the best interest of the corporation to enter this new field and proceed with the construction of a new boat upon the improved design of Slo-Mo-Shun III, all with the end in view of when the time was propitious getting into commercial operation.

"Mr. Sayres was authorized to proceed accordingly.

"At this time Slo-Mo-Shun IV was in the process of being built. It was launched in October, 1949.

"At some time before October 31, 1949, the corporation paid to the petitioner an amount of $14,690.30, which was the amount that had been expended by the petitioner in the construction of Slo-Mo-Shun III and of partial construction of Slo-Mo-Shun IV.

"In 1949 there was no registration or licensing requirements with regard to boats of this character. The petitioner did not enter into any formal document transferring title of either Slo-Mo-Shun III or Slo-Mo-Shun IV to the corporation. There was no patent on the design of these boats.

"The petitioner filled out forms with the county assessor of King County, Washington, for personal property tax purposes, as of January 1, 1950 and 1951, indicating that he was the owner of Slo-Mo-Shun IV. The petitioner left blank the part of such forms calling for information as to whether he had transferred title. He belonged to the Seattle Yacht Club and has always been registered with the American Power Boat Association as the owner of Slo-Mo-Shun IV and V. The rules of that association provided, among other things, that each boat entered for a sanctioned race must be the bona fide property of the person in whose

name she is entered, who must be a racing member of the association and a member of a club belonging to the association; that corporations or business concerns may not enter sanctioned races (although they may be members of the association) and may only enter a boat as the bona fide property of a club member who is also a racing member of the association, either by ownership or by charter.

"On June 26, 1950, Slo-Mo-Shun IV, driven by the petitioner on Lake Washington, established a new world straightaway speed record of 160 m.p.h., breaking the 11-year-old record of 141 m.p.h. Recognizing the capabilities of this boat and the possibility of still further improvements of design in a model to be built, the petitioner sought a contractual arrangement which would include Ted Jones, the designer, and Anchor Jensen, the builder. However, because of disagreement as to technical engineering principles Jones refused to sign an agreement which would include Jensen as a party. On July 17, 1950, an agreement was executed 'by and between American Properties, Inc. (and/or S. S. Sayres), Party of the First Part, and Ted O. Jones, Party of the Second Part,' which provided that whereas the first party had financed construction of Slo-Mo-Shun III and Slo-Mo-Shun IV and whereas second party designed both of those boats and assisted in development, construction, and testing, the parties agreed as follows: The second party agreed to work exclusively for the first party in the design and development of 'Gold Cup' and 'Unlimited' classes of racing boats during the existence of the contract and a period of one year thereafter; second party agreed not to disclose to others any basis or essential features of design, construction, or develop-

ment; first party agreed that when constructing racing boats only second party would be employed to design such boats and to supervise construction, and that upon all boats sold by first party, in whom title should always rest, second party would receive a fee of $5,000 or 10 per cent of sale price, whichever was greater, this being in addition to time and material charges such as had been paid in the past; first party agreed that if Slo-Mo-Shun IV should be sold for an amount greater than cost, first party would pay second party 10 per cent of actual net profit after taxes, or a flat sum of $5,000, whichever was greater, in which case second party would, in consideration thereof, design a new 'Unlimited' class racing boat for first party at no additional fee; both parties agreed that in event of any sale of plans and designs of 'Gold Cup' and 'Unlimited' boats, first party would pay second party a fee of $2,500 together with traveling expenses and a fee of $25 per day actually spent in supervising construction. It was provided that the agreement should continue until terminated by written notice of either party, giving 180 days' notice. It was signed by S. S. Sayres as president of American Properties, Inc., and in his individual capacity, and by Jones.

"On July 22, 1950, Slo-Mo-Shun IV, driven by Ted Jones, won the Gold Cup race. Following that Jones was approached by others seeking boats of the design of Slo-Mo-Shun IV. Horace Dodge sought to have two boats built, offering $50,000 per boat. Jones sought approval of the petitioner which was refused.

"Slo-Mo-Shun IV, driven by Lou Fageol, won the Harmsworth Trophy on August 2, 1950.

"In August, 1950, the Seattle-First National

Bank loaned American Properties, Inc., $26,000 to be used in operations in connection with the boats. No collateral was given for the loan.

"In February, 1951, construction of Slo-Mo-Shun V was commenced for the purpose of entering the 1951 Gold Cup races. The petitioner prevailed upon Jones and Jensen to work together in the construction of the boat. The boat was constructed at the premises of the Jensen Motor Boat Company under the supervision of Jones and with the aid of some of Jensen's boat builders. The boat was completed by the end of July, 1951. Jones received $5,000 for designing Slo-Mo-Shun V in addition to compensation received on an hourly basis for its construction.

"Lou Fageol, a wealthy sportsman who was one of the top two or three drivers in the country, drove Slo-Mo-Shun V and won the Gold Cup in 1951.

"In 1952 Slo-Mo-Shun IV, driven by Stanley Dollar, a wealthy man of the Stanley Dollar Steamship Lines, won the Gold Cup race. Joe Taggart, who has had as much racing experience as Fageol, also drove the Slo-Mo-Shun boats in competition. In 1953 and 1954 either Slo-Mo-Shun IV or Slo-Mo-Shun V won the Gold Cup races. The Slo-Mo-Shun boats have also won the Martini-Rossi Trophy for the fastest heat in a Gold Cup race and the Aaron DeRoy Plaque for the fastest over-all average. The petitioner's name appears on the Gold Cup as the winner and the various trophies which were won by Slo-Mo-Shun boats were kept at the Seattle Yacht Club. There were no cash prizes in racing these boats.

"The petitioner did not himself personally drive

any of the boats in closed course competitive races, such as the Gold Cup or the Harmsworth races. He did drive in speed competition, as in 1950 when he broke the world's straightaway speed record.

"About November 1, 1951, Ted Jones left Seattle and went east to work as a boat designer for another concern. He thus ceased to operate under the agreement of 1950. No formal notice of termination of the contract was ever given by either party. Because he felt restrained by the contract of 1950, Jones did not, for a number of years, build any boats for others of the design of the Slo-Mo-Shun boats, although he had many opportunities to do so. However, commencing in January, 1954, he did design a number of boats for various individuals throughout the country, employing the design of the Slo-Mo-Shun boats. At the time of the hearing in this case in 1956, there were about 20 boats eligible for competition in the unlimited class, of which all but four were of the basic Slo-Mo-Shun design.

"The members of the crew of these boats included highly skilled technicians who worked on the various Slo-Mo-Shun boats in their spare time since they were full-time employees of other organizations. None of them was employed by either American Properties, Inc. or American Automobile Company. Jones was compensated for designing the boats and Jensen was paid for his work in building them.

"The principal construction work took place at the Jensen Motor Boat Company, but the engine work was done at the premises of American Properties, Inc., then under lease to American Automobile Company, where there was a machine shop for assembling engines. The small hand tools

which were used were the property of American Properties, Inc. Only occasionally was equipment of American Automobile Company used. An electric hoist which was used was not the property of American Automobile Company. Engines and parts were stored at these premises.

"All costs of completing and operating Slo-Mo-Shun IV and the cost of building and operating Slo-Mo-Shun V were borne by the corporation, including the expenses incurred in racing them, such as traveling expenses of the crew to Detroit in 1950.

"The building owned by the American Properties, Inc. was located about one and one-half to two miles from the nearest navigable body of water. Slo-Mo-Shun III was moored at a dock at the petitioner's residence on Lake Washington to which he moved in December, 1950, and the Slo-Mo-Shun boats were then housed in the boat house at such residence. At times the boats were housed at the Jensen Motor Boat Company, which is on Lake Washington about five miles from the petitioner's new residence.

"Greater Seattle, Inc., a nonprofit, publicly subscribed corporation which promoted the annual Seafair and other sporting events, sponsored campaigns to raise money for the operation of the Slo-Mo-Shun boats because of the advantage to Seattle of bringing the Gold Cup race to Seattle. In 1950 the amount contributed by Greater Seattle, Inc. for this purpose was $6,912.15. This contribution, whether paid to the petitioner in the first instance, or to the corporation, was ultimately received by the corporation to defray part of the expense of operating Slo-Mo-Shun IV. In subsequent years other contributions were also received from

Greater Seattle, Inc. through campaigns for public subscription. In sponsoring campaigns for raising money for this purpose, Greater Seattle, Inc. held the petitioner out as the owner of the boats. Newspaper articles also consistently referred to the petitioner as the owner of the boats. The official programs of the Gold Cup races listed him as the owner.

"The petitioner has never sold any of the Slo-Mo-Shun boats or any designs therefor. After Slo-Mo-Shun IV had been constructed some civilian representatives of the Navy Department examined it and observed it in action. There was no subsequent indication that the Navy would be interested.

"In its income tax returns for the calendar years 1949 and 1950 the corporation shows its principal business activity as 'Real Estate' and 'Lessor of Building,' respectively. It reported net income of $8,423.26 in 1949 and a net loss of $1,561.41 in 1950. Its returns show that it had surplus at December 31, 1949, of $74,659.49 (of which $37,497.43 was earned surplus) and at December 31, 1950, surplus of $71,260.73 (of which $34,-098.67 was earned surplus).

"In the calendar year 1949 the corporation expended $2,155.56 in operation and maintenance of the boats, which it deducted on its corporate tax return as business expenses. The respondent disallowed this amount to the corporation. In addition, the corporation expended $561.39 as additional boat expense which it did not deduct on the corporate return.

"For the calendar year 1950 the corporation expended $19,300.58 for operation and maintenance of the boats and deducted on its return the amount of $12,388.43 (after offsetting the contribution

from Greater Seattle, Inc., in the amount of $6,-912.15). In the return there was included $1,000 as income from endorsement of an oil product. In this situation the respondent considered that there had been claimed a net deduction of $11,388.43, which he disallowed.

"The corporation capitalized on its books and its returns for 1949 and 1950 the amounts expended for construction of the boats and related equipment (including the amount of $14,690.30 which was paid by the corporation to the petitioner as hereinabove stated). In the 1949 return the balance sheet at the end of the year includes in depreciable capital assets the amount of $18,609.16 for boats and equipment, but no depreciation was claimed. For 1950 the amount of capitalization of boats and equipment at year end was $22,323.37 upon which depreciation was allowed in the amount of $5,-830.84, which was disallowed by the respondent. The respondent included as additional income of the individual petitions all amounts expended by the corporation in connection with the boats. Inasmuch as the individuals were on a fiscal year ending October 31, whereas the corporation was on a calendar year basis, the respondent determined the amounts which had been expended during the taxable year of the individuals. For the fiscal year ended October 31, 1949, the respondent attributed additional income to the individuals in the amount of $16,401.51, consisting of $1,149.82 of disallowed corporate expenses to October 31, 1948; $561.39 representing additional boat expense paid by the corporation and not deducted on the corporate return, and $14,690.30 representing the amount paid to the petitioner by the corporation and capitalized on the corporate return. For the fiscal year

ended October 31, 1950, the respondent attributed additional income to the individuals in the amount of $16,595.31, consisting of $1,005.74 expended by the corporation as boat expenses from November 1, 1949, to December 31, 1949; $7,956.50 of net expenses from January 1, 1950, to October 31, 1950, and $7,633.07 expended during the year ended October 31, 1950, and capitalized by the corporation.

"On June 29, 1951, the corporation filed a claim for refund of taxes for the year 1949, based upon the carry-back of a claimed net operating loss for 1950. On August 19, 1952, the corporation filed another claim for refund for the year 1949, based upon a claim that it understated its net operating expenses by the amount of $561.39 referred to hereinabove." (Tr. 27-40)

It should be noted that in addition to the facts found by the court the following facts were adduced at the trial: That as early as July 17, 1950 (three weeks after Slo-Mo-Shun IV had set the world's record and five days before the 1950 Gold Cup race) the rift between Jones as designer and Jensen as builder had already progressed to the point where Jones refused to sign the original draft of Exhibit 1 because Jensen was also a party to it (Tr. 94-95, 211-212).

The disagreement between Jones and Jensen progressed to the point that in the fall of 1951 Jones left American Properties, Inc. to go with the manufacturer of Mercury outboard motors (Tr. 99-100). His engaging in the production and sale of racing boats for profit is his sole livelihood (Tr. 99-100, 202, 204-205, 209-212).

Sayres testified that the "prime thing" or "primary

motive or purpose'' in going into the construction of the boats was the business opportunity (Tr. 101-103).

The late Tracy E. Griffin, attorney for Sayres and all of his business interests since Sayres' arrival in Seattle in 1931, a past president of the Washington State Bar Association, Seattle Bar Association, and delegate to the American Bar House of Delegates (Tr. 162-163), testified that the resolution of the Board of American Properties, Inc., Exhibit 4, represents a bona fide meeting of the board on or about August 31, 1949 (Tr. 162-164). He further testified:

> ''Mr. Sayres very definitely entered into this venture with the idea of not only having it pay its own way, but of being a profitable enterprise. I heard his testimony in regard to the Navy situation, I confirm that conversation with him. It was days back there (*sic*) where he was very optimistic and the optimism continued in—
>
> Q (interrupting) Optimistic in reference to what?
>
> A. In being able to have a new profitable venture in the building and construction of these boats, the sale of boats, the sale of rights to the boats, perhaps certain marine equipment as time went on.'' (Tr. 164)

Albert R. Munger, retired president of the Seattle-First National Bank, testified in reference to Sayres consulting him about the profit possibilities of these boats:

> ''A. Well, so far as the business aspect of going into the manufacture and sale of boats was concerned, his question of me was my opinion on the desirability of entering into that venture as a business enterprise.

Q. And specifically doing what in a business way with the boats?

A. To make an arrangement with Ted Jones and Anchor Jensen whereby the three together would be interested in the building and the sale of boats of the type that Mr. Jones had designed.

Q. What ultimately evolved in that discussion?

A. Well, my advice to Mr. Sayres was favorable to the venture — I advised him that in my opinion it was sound and promising business venture.

Q. And did you make any recommendation to him as to any corporate organization?

A. I cannot distinctly remember making any recommendation on my part, but I was a party to the discussions that involved in what ownership and in what form that business should be conducted. I had only one stipulation in respect to the base interest (*sic*) that he should not enter it individually.

Q. I see. I take it from that he should either organize or select a corporation?

A. That was the effect of it.

Q. Did you ever hear the subject of the Navy mentioned or discussed in any of those conversations?

A. Oh, yes.

Q. In what regard?

A. Well, it was one of the factors that was of importance in making up one's mind as to the desirability of the business venture, and the circumstances were that we all had in mind the experience with the PT boats during the war with the thought that they had been extremely valuable to the Navy and that it might very well be that

the Navy would become a very important customer for this business venture in the development and purchase of the successor models of the PT boats for use in rescue and in all other affairs where speed was the prime requisite because in my opinion it was evident that a boat designed along these lines would be far speedier and more useful to the Navy than the PT boats had been in the recently ended war.

Q. Other than the Navy and/or Coast Guard or other government user of high speed boats, what other prospective purchaser or purchasers was it anticipated would buy this type of high speed vessel?

A. Well, in my thinking there were probably a large number of prospective purchasers for these reasons, first, it was evident in our minds at least, that Ted had designs here that would just revolutionize the capacity and the construction of these unlimited hydroplanes, in the second place, he was able to build them for what seemed to me a rather modest cost, in the third place, that those people interested in owning and operating racing boats of this type had been accustomed to spending much larger sums for their boats, and that they would readily pay prices for these new developments that might run to two or three times the actual cost of producing the boats. In other words, it could be very profitable.

Q. Did you, when I say you, I mean your bank, the Seattle-First National Bank, have any occasion to invest by loan or otherwise in this venture?

A. Mr. Sayres borrowed for the American Properties, Inc., a sum of money that I think was between twenty-five and thirty thousand dollars,

some time after our conversations, and I think probably in the year 1950.

Q. Did you approve that loan or at that time were you on the loan committee, do you recall?

A. I was chairman of the loan committee, but I was not an active loan officer, that loan was made by a loan officer in one of our branches. It came before me for approval in the normal run of the bank's business.

Q. The borrower on that loan was who?

A. American Properties, Incorporated." (Tr. 170-172)

Ted Jones, called as a witness by the respondent, testified that, after designing Slo-Mo-Shun IV and V, he designed the Breathless for J. Murphy; Miss Thriftway for Associated Grocers; the Rebel Suh, Gail VI for Joe Schoenith; a boat for Henry J. Kaiser; the Wahoo for Bill Boeing, Jr.; the Shanty for W. T. Waggoner; a spare hull each for Boeing and Waggoner; and redesigned the Gails, Such Crust (owned by Jack Shafer), Tempo (Guy Lombardo) and Supertest (Tr. 202-204). Under direct examination by respondent's counsel, he testified that these boats are exceptionally seaworthy and built for rough water usage and would be usable as a PT boat if the length of the hulls was stretched out to 50 feet (Tr. 208-209). He further testified on cross-examination:

"Q. Now, Mr. Jones, I take it that when you and Mr. Sayres signed this agreement, Exhibit 1, you were anticipating what would happen in the event of a sale of either of the boats of the design or of the class that you had designed, or of the plans for those boats, were you not?

A. Yes.

Q. That is the arrangement provided for for you in that agreement?

A. That is right.

Q. Did you and he anticipate that that might be a likelihood, that is to say, that the design may be in demand for boats produced—

A. (Interrupting) My entire life has been devoted to come up with something fast in the water, and I was very sure that when it was proven that it would finally pay off.

Q. And be profitable?

A. Right.

Q. And you ultimately have made that your career, have you not?

A. That is right.

Q. And these boats that you have referred to as being designed by you for various people throughout the country are on this principle of the IV and V, are they not?

A. Yes, they are.

Q. And at the time that that design was perfected in IV and V, it was a revolutionary design in reference to the construction of unlimited hydroplanes which preceded it, is that right?

A. As far as the unlimited, yes, but it was identical to my limited boats that I had been racing for a good many years.

Q. You were interested and prompted, I take it, by, and are now, are you not, by profit incentive as well as a natural interest in the subject, are you not?

A. Yes.

Q. Do you now make your living or is your income now solely derived from this pursuit?

A. It is." (Tr. 209-210).

QUESTIONS INVOLVED

(a) Did Petitioner, American Properties, Inc., enter into and carry on a racing boat venture with a profit motive in the calendar years 1949 and 1950, thereby incurring ordinary and necessary expense in the maintenance, operation and depreciation of said boat?

(b) If the answer to (a), *supra,* is "No," then were the amounts so expended by said corporation taxable income to the sole stockholders, Stanley S. Sayres and Madeleine A. Sayres?

(c) If the answer to (b), *supra,* is "Yes," then was the racing boat venture entered into by Mr. and Mrs. Sayres with a profit motive, rendering the expense of maintenance, operation and depreciation deductible?

Needless to say, the Tax Court by decision dated February 14, 1958, (Tr. 60) decided that the expense of the boats was not deductible to American Properties, Inc., and such expense was taxable income to Mr. and Mrs. Sayres.

SPECIFICATION OF ERRORS

1. The finding of the Tax Court that "during the years in question the activities of the petitioner and the corporation with respect to the boats were not conducted with the intention of making a profit and that such activities did not constitute the conduct of a trade or business by either the petitioner or the corporation" (Tr. 51), is clearly erroneous.

2. The finding of the Tax Court that American properties, Inc., was "not entitled to deduct the cost of maintenance and operation of the boats under section 23 (a)

(1) of the Internal Revenue Code of 1939, as ordinary and necessary expenses paid or incurred in carrying on a trade or business and that it is not entitled to deductions for depreciation on the boats, irrespective of whether title to the boats was in the corporation, since section 23 (1) requires, as a condition to such depreciation deductions, that the property be used in a trade or business'' (Tr. 51-52), is clearly erroneous.

3. The finding of the Tax Court that ''the respondent's determination that the amounts in question are taxable to the individual petitioners is approved'' (Tr. 53), is clearly erroneous.

4. The finding of the Tax Court that ''neither the corporation nor the individual petitioners was engaged in the business'' and that the expenditures in connection with the boats may not be deducted by the individual petitioners (Tr. 53) is clearly erroneous.

5. The finding of the Tax Court that ''We believe that the parties had in mind merely the possibility of entering into a commercial venture at some future time when it might be deemed expedient to do so'' (Tr. 47) is clearly erroneous.

6. The Tax Court erred in entering its decisions in these consolidated cases that there were deficiencies in income tax for the taxable years 1949 and 1950 as to American Properties, Inc., and in the fiscal years October 31, 1949, and October 31, 1950, as to the individual petitioners (Tr. 59-60). It should be here noted that error is only assigned to that portion of the decision involving the question of the deductibility of the boats to American Properties, Inc., and the concomitant in-

crease in income to the individual petitioners. It should be further noted that no error is assigned by reason of the court's decision of salary questions or the assessments of negligence penalties occasioned by salary questions.

The reason why petitioners on review point out the fact that they do not assign the salary and penalty questions as error is that in clear violation of the last sentence of this Court's Rule 17 (6), the respondent has caused the entire transcript of the testimony to be printed by its cross-designation when, as is apparent, a large portion of that transcript of testimony (Tr. 40-43, 53-58, 185-201, 218-219, 228-234) pertains only to salary and penalty issues. It is further noted that respondent did not designate for printing the petitions in Tax Court docket Nos. 57749 and 57750, which raised the salary and penalty questions. Petitioners here invoke Rule 17 (6) as to the printing of those portions of the transcript of the testimony on which no issue is joined in this court.

ARGUMENT

Counsel for the respondent aptly stated in the trial court the issue: "Your Honor, this whole case rests on the business motive versus the hobby motive" (Tr. 145).

It is interesting to note that Sayres went into the automobile business through the American Automobile Company (now Stan Sayres, Inc.) as a result of his interest in driving automobiles at high rates of speed. No one contends or could contend that the corporate

income of that business was the personal income of Sayres because speed was his hobby.

The Venture Was Entered Into With a Profit Motive

A full reading of the court's opinion (Tr. 25-40, 44-53) discloses that despite the court's opinion and conclusion that the boat venture was gone into with a bona fide profit motive that the court arrived at its decision by the further conclusion that the business venture never materialized. This, we submit is in error.

As will be demonstrated by authorities hereinafter cited, it is clearly not the law that enjoyment of one's business enterprise converts it from a business to a hobby. It is apparent that the theory of Sayres was, when he and Jones and Jensen became convinced that they had the fastest boat in the world abuilding, that it could be profitable only by breaking the world's record and proving itself in competition, thereby focusing the attention of the racing world (and any other interested persons) on the prototype, Slo-Mo-Shun IV.

The future proved Sayres' predictions to be correct, *i.e.,* the Slo-Mo-Shun IV conclusively smashed the world's record on June 26, 1950, and a few weeks later the boat invaded Detroit and conclusively won the Gold Cup Race.

It is not without significance that Jones left American Properties, Inc., in 1951 and went on with the venture on his own account, makes a handsome profit at it and engages in it as his sole and exclusive means of livelihood. His dominance in the field is exemplified by the fact that of the 20-odd unlimited class hydroplanes

in existence, he has designed all but approximately four. To conclude that this venture is not one capable of profit is unwarranted.

The fact that Sayres did in fact go into the venture through American Properties, Inc., with a bona fide profit motive cannot in honesty be disputed under the unequivocable testimony not only of Sayres (who was well enough respected in his own community of over half a million people to be named as its "Man of the Year") (Tr. 125-126), but of his counsel, his accountant and his financial advisor, when such testimony was neither challenged nor capable of challenge.

The only apparent challenge made by the respondent was the quibbling over the record title to the vessel when the evidence showed there was no record title (Tr. 95-96) because the transfer was made at a time when the boat was not even completed. It appears to be the respondent's position that the title was in Sayres because the public thought so, and that it is a plaything of a wealthy sportsman because he is wealthy and enjoys "test-hopping" of the boat (Tr. 100-103).

There can be no doubt as to the applicable law. More than twenty years ago the proper test was announced:

> "The proper test is not the reasonableness of the taxpayer's belief that a profit will be realized, but whether it is entered into and carried on in good faith and for the purpose of making a profit, or in the belief that a profit can be realized thereon, and that it is not conducted merely for pleasure, exhibition, or social diversion. . . . " *Doggett v. Burnett* (1933) 65 F.2d 191.

> "The intention of the taxpayer at the outset is

the dominant factor in determining whether he engaged in the venture merely for pleasure or for profit." *W. S. Farish v. Commissioner* (1939) 103 F.2d63; *S. P. Farish v. Commissioner* (1939) 103 F2d 65. See also *Commissioner v. Field,* 67 F.2d 876; *Doggett v. Burnett, supra; Thacher v. Lowe,* 288 Fed. 994; *Edwin S. George,* 22 BTA 189.

The respondent's case consisted of a showing that Sayres referred to it as his boat, signed assessor's tax returns (Exs. I and J) and the boat was entered in Sayres' name in competition.

There was, of course, no documentary evidence of title (Tr. 95-96). It is at once apparent from an examination of the assessor's return that its purpose is to arrive at a *value,* not the ownership of the boat. The assessor in sending the return to Sayres for signature doubtless assumed, as apparently the newspapers and public did, that Sayres was the owner. Sayres could see no purpose (and neither do we) in indulging in detailed explanations to the public that they were in error in referring to him as the owner, since there is no interest in the subject (Tr. 148-149).

The Tax Court held that in any event the question of whether title passed from Sayres to the corporation was not itself decisive of the issues presented (Tr. 45).

As to the entry of the boat in competition as Sayres', it is clear that this was required by the rules of the American Power Boat Association (Tr. 149-157, Ex. 5). In this connection it will be noted that Miss Thriftway, owned by Associated Grocers (who operate the "Thriftway" Stores) is entered in competition as being

owned by Willard Rhodes (Tr. 148-157, 203-204, Ex. U, p. 17), an executive of the company actually owning it, and that such was the practice with other racing boats owned by commercial firms.

That petitioner's incentive was profit has been clearly pointed out by previous references to the record.

Section 23 of the Internal Revenue Code of 1939, to which the Tax Court referred in its opinion, states:

> "In computing net income there shall be allowed as deductions:
>
> "(a) Expenses.
>
> "(1) Trade or business expenses.
>
> "(A) In General. All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . .
>
> "(e) Losses by Individuals. In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—
>
> "(1) if incurred in trade or business; or
>
> "(2) if incurred in any transaction entered into for profit, though not connected with the trade or business. . . . "

While it is true the operation was not profitable for the years in question, the fact of recurrent losses is not sufficient ground for denial of the relief asked.

> "That the petitioner did not claim a deduction for losses prior to 1927 and that the stable was unprofitable for the eight years it had existed will not support the decision (against the taxpayers) of the Board under the evidence in the case." *Whitney v. Commissioner* (1934) 74 F.2d 589.
>
> "The whole question here is to determine wheth-

er, as a matter of fact, the intention of petitioner has been to realize a profit from the operation of this farm, and this question may not be determined solely from the recurrence of losses." *Israel O. Blake v. Commissioner* (1938) 38 BTA 1457. See also *Lillie S. Wegeforth v. Commissioner* (1940) 42 BTA 633; *Commissioner v. Field* (1933) 67 F. 2d 876).

Petitioners should not be denied deductions simply because they derived pleasure and fame from their business and were able to absorb losses.

"The fact that petitioners were wealthy enough to afford a hazardous occupation in which they found pleasure despite discouraging losses does not establish the essential nature of the occupation. If they were utterly indifferent to whether there was loss or gain, or if it were shown the stables were an incident to the social or domestic aspects of their daily lives, the result might be against them as in *Thacher v. Lowe* (D.C.) 288 Fed. 994, 2 AFTR 1931. Instead it appears they devoted themselves seriously and assiduously to the economic promotion of their stables, always in the hope that profit would result. The winning of a single race or the chance purchase of a yearling might at any time convert steady losses into a net profit, and make it a successful business." *Commissioner v. Widener* (1929) 33 F.2d 833.

As was said in *Black Dome Corp.,* 5 TCM 455, §46, 130 P-H Memo TC 1946).

"It is clear that throughout this period petitioner's activities were directed towards the realization of profit from the operation of petitioner's property and not for the pleasure and recreation of petitioner's sole stockholder." (Citing *Marshall-*

Field, 26 BTA 116, aff'd 67 F.2d 876). "The fact that petitioner's property had not been operated at a profit for many years does not require a different conclusion."

The profit and loss or other financial statement of a venture does not purport to classify it as being a business or a hobby.

> "An occupation or employment will not be excluded from the classification of business merely because it actually results in loss instead of profit; but it is essential that livelihood or profit be at least one of the purposes for which the employment is pursued." *Deering v. Blair* (1938) 23 F.2d 975, 976.

Here, as in the *Whitney* case, *supra,* there is "no substantial evidence to support the conclusion that the pleasure of owning (the business) was the primary interest of the petitioner in operating it."

> "If it can be shown the subsidiary enterprise was operated with the motive of eventual profit, the expenses thereof and any losses are deductible even though the enterprise is of a kind usually considered a hobby or recreation." *NYU Ninth Annual Institute on Federal Taxation* (1951), page 337 *et seq.*

and:

> " . . . that purpose (pecuniary gain) need not be exclusive. It is sufficient if the profit aim is the prime thing. . . . " *George F. Tyler* (1947) 6 TCM 275, §47,058 P-H Memo TC.

The allowance of losses has not been predicated upon the particular type of occupation. Losses have been held deductible in:

G. F. Tyler, supra, stamp collector;

J. L. Byrne, 4 TCM 1096, §45,371 P-H Memo TC 1945, dog kennel;

Doggett v. Burnett (1933) 65 F.2d 191, religious publications;

Amos J. Bumgardner, infra, dog kennel operated by dentist;

Blake v. Commissioner (1938) 38 BTA 1457, horse stable;

Black Dome Corp., supra, operation of estate grounds, lake, etc.

Neither can the losses be denied on grounds petitioners have other principal sources of income.

> "Deduction of a loss is not to be denied by reason of the fact that the taxpayer has one or more other enterprises from which he receives his principal source of livelihood." *NYU Ninth Annual Institute on Federal Taxation* (1951) page 337, *et seq.; Marshall Field* (1936) 26 BTA 116, aff'd 67 F.2d 876; *Moses Taylor* (1927) 7 BTA 59.

As noted, the determination of the taxpayer's intention is most important. A recent case, *Amos J. Bumgardner,* 13 TCM 128, §54, 047 P-H Memo TC, 1954, has set forth indicia of such intention, as follows:

(1) A thorough preliminary exploration of the field and the possibilities of profit. *Irving C. Ackerman* (1931) 24 BTA 512, aff'd 71 F.2d 586.

(2) The consultation of experts and the hiring of qualified help or assistants. *Margaret E. Amory* (1931) 22 BTA 1938.

(3) Considerable personal attention to the enterprise. *Laura M. Curtis* (1933) 28 BTA 631.

(4) And a businesslike method of accounting for income and expenses and concern for the economics of the operation. *Wilson v. Eisner* (1922) 282 Fed. 38.

A brief summary of the evidence clearly shows petitioners' intention to engage in a profitable business. They made a thorough examination of the field, built and tested prior boats, made a trip to the 1948 Gold Cup in order to appraise, examine and analyze the then fastest boats; and Sayres deliberated the possibilities of profit with his attorney, accountant and financial advisor. For design he consulted with and hired Ted Jones, the foremost authority in the nation; as builder there was Anchor Jensen, a Northwest boat builder of high repute; for mechanics and crewmen there were, among others, Mike Welsh, a highly-skilled technician in electronics, Elmer Leninschmidt from Western Gear Works. The drivers of the Slo-Mo-Shun were the best in the business, Joe Taggart, Lou Fageol, and Stan Dollar. That the enterprise was time-consuming and demanded the personal attention of Sayres is clearly shown. There were stockholders' meetings, consultation with attorneys, accountants, bankers, discussions with Jones, Jensen and crewmen, trips to Detroit, testing of boats, experimentation of gear, motors and equipment, etc. Further, books of account were properly kept and concern for the economics of the operation is evidenced by requests for advice from competent persons. Bank loans were made in a normal businesslike manner. In short, Mr. Sayres did all, even more than could be expected of a prudent businessman.

In this connection it is to be noted that the Tax Court

found as a fact (referring to Sayres, Jones and Jensen) that

> "They recognized the tremendous room for improvement in the designing of racing boats. At that time they also recognized the possibility of profit to be made in the designing, construction and sale of racing boats. They considered the possibility that the Navy might become interested in the basic design of these fast boats and might become an important customer. . . .
>
> "The petitioner had consulted his attorney, his accountant and his financial advisor, an officer of the Seattle-First National Bank, who all agreed on the profit possibility in the designing, building and sale of boats." (Tr. 28-29)

The Tax Court Misconstrued the Language of the Resolution of American Properties, Inc. of August 31, 1949 (Ex. 4)

It is apparent from a reading of the opinion of the Tax Court that the Court arrived at its conclusions partially from a misconstruction of the meaning of Exhibit 4, Minutes of the Meeting of Directors of American Properties, Inc., held August 31, 1949. Those minutes are set out in full in the Findings, *supra* (Tr. 30-31), and in part stated:

> "It was agreed that it was to the best interest of the corporation to enter this new field and proceed with the construction of a new boat upon the improved design of Slo-Mo-Shun III all with the end in view of when the time was propitious getting into commercial operation." (Exhibit 4, Tr. 31)

The Tax Court concluded (Tr. 48): "This left the

intended time of actually entering into business in an uncertain state." This is the basis for the Court's finding that "the parties had in mind merely *the possibility* of entering into a commercial venture at some future time when it might be deemed expedient to do so" (Tr. 47). What is apparent is that what was left for the future was "getting into commercial operation," not getting into business.

Furthermore, Sayres testified:

> "Q. By the way, to the extent that there may be confusion about it, this Exhibit 4, being the resolution of American Properties of August 31, 1949, is that the date upon which your conception of this being a profitable venture actually materialized?
>
> A. That is the date on which we said, 'Here we go.' " (Tr. 97-98)

It is abundantly clear from the record that American Properties, Inc., in a bona fide honest, businesslike manner determined to and did enter into a venture with a profit motive and did forthwith as the resolution and the facts indicate "proceed with the construction of a new boat upon the improved design." The resolution showed that the company believed that it had to do "the necessary experimental and engineering work" and "it was recognized that there would be substantial experimental cost to lay the groundwork for future development" and that the corporation was to "continue in an endeavor to work out improvements in design and engineering. He (Sayres) particularly suggested that a new, improved Slo-Mo-Shun should be designed and built for actual racing use" (Ex. 4, Tr. 30-31).

It seems clear to us that this manifested a *present*

intention to commence on a business basis and with a profit motive the construction of unlimited hydroplanes. Within 60 days the corporation had carried out the intention and had physically completed Slo-Mo-Shun IV which fulfilled every prophecy made for her while she was on the drawing boards.

What is apparent is that the lower Court has construed the resolution and the conduct of the taxpayers as meaning that some time in the future they might evolve a business purpose from this project. This is patently not true. The purpose which the directors had in mind and which they clearly articulated in plain and concise language was that the actual sale of boats would necessarily have to follow the performance of the pilot model then on the drawing boards and that if that vessel made a record for itself, they would then be able to get into "commercial operation," which we deem to mean marketing boats, designs, and the like. To conclude, as the Tax Court did, that this resolution merely manifested a future intent to embark on a commercial venture is simply not supported by the language used, the conduct of the petitioners, nor by any portion of the record.

We think it further unwarranted to conclude from this resolution, from the absence of a record title, and from the rejection by Sayres of one isolated offer to build for Horace Dodge that ergo, the construction, maintenance and operation of the boat was Sayres' personal hobby.

The Boat Was Not a Personal Hobby

The unchallenged fact (which, indeed, the trial court

found to be a fact (Tr. 35)) that Sayres never drove the boat except on the occasion that it broke the world's straightaway record and occasionally in testing new equipment, seems to us to be inconsistent with the court's conclusion that the boat was the personal hobby of Sayres. It should be apparent that these boats are designed and used as racing boats and that Sayres never drove them except on the occasions mentioned.

It should be further noted that there is no prize money in racing the boats and the court so found (Tr. 35). Any analogy to owning race horses is clearly inapplicable.

The boats can certainly not be classified as a pleasure craft (Tr. 89):

> "Q. Is it fair to state, then, that your desire or enthusiasm for speed is not satisfied by driving the Slo-Mo-Shun IV or V in racing competition, you do not satisfy it in that manner?
>
> A. No, I would like to, but there are some good reasons not to.
>
> Q. And you haven't?
>
> A. I have not.
>
> Q. Other than the original breaking of the world record in June 23, 1950, have you driven these boats or either of them competitively?
>
> A. No." (Tr. 88-89).

The Tax Court concluded that petitioner's refusal to accept one isolated offer to purchase boats "is certainly not consistent with the claim that he was interested in profit. On the contrary it indicates a continuation of the hobby for his personal pleasure and satisfaction"

(Tr. 49-50). If such were the fact, the conclusion would still be not valid, but the fact is that no one ever made any direct offer to Sayres to purchase boats (Tr. 141-142). In fact, the trial judge summarized his testimony as follows:

> "As I understand it, the witness has said that he had had some indirect offers and if it had been a big enough price, he would have sold. And he says that he did say at this time that he would not sell, however, unless he had another boat to defend in the races.
>
> THE WITNESS (Sayres): 'Yes, sir, that is correct.' " (Tr. 145).

Sayres further testified:

> " . . . had I sold it in 1950 that would have probably ended any hopes I had of going on with the development, continuing development and getting into the boat business. It could have. That is a question that nobody can answer flatly." (Tr. 142).

It should also be borne in mind that Slo-Mo-Shun IV was not built and improved for the purpose of selling that particular boat. It was built as a pilot model of a new design (Tr. 147). The company would have had to start another boat to continue the development of design and equipment.

We submit that the overwhelming weight of the evidence clearly demonstrates that:

1. American Properties, Inc., engaged in the racing boat venture as a trade or business with a profit motive and that the ordinary and necessary expense incurred in that venture was deductible pursuant Section 23 (a) (1) of the Internal Revenue Code of 1939.

2. The expense would be in any event deductible to the individuals as a "transaction entered into for profit, though not connected with the trade or business," under Section 23 (e) of the Internal Revenue Code of 1939.

We respectfully submit that the decision of the Tax Court be reversed.

Respectfully submitted,

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APPENDIX

In conformity with Rule 18, subdivision 2 (f), the following is a list of the exhibits which were identified and received or rejected at the following pages of the Transcript of the Record:

Petitioners'	*Identified*		*Admitted*
1	93		94
2	91		92
3	92		92
4	93		93
5	149		149
6	172		175
7	190		193
8	191		191
9	194		194
10	223		226
Respondent's			
A	74		74
B	76		76
C	103		103
D	103		103
E	103		103
F	103		103
G	103		103
H	103		104
I	105		106
J	105		106
K	108		109
L	108		111
M	111	Rejected	116
N	129		130
O	130		131
P	131		133
Q	136		140

Respondent's	*Identified*		*Admitted*
R	136		140
S	136		140
T	136		140
U	136		140
V	143	Rejected	147
W	229		230